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The Joint Office, Transporters, Shippers and
other interested parties

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18 January 2006

Dear Colleague,

Uniform Network Code modification proposal 032: 'Adjustment to the number of days in the VAR calculation to bring the Code Credit Rules into line with the Best Practice Guidelines, Conclusions document Feb 2005'

Having considered the issues arising from this proposal Ofgem[1] has decided not to direct the implement the modification, as Ofgem does not believe that it will better facilitate the achievement of the relevant objectives of the Uniform Network Code (UNC), as set out in standard special condition A11[2] of relevant Gas Transporters Licences.

This letter explains the background to the modification proposal and outlines the reasons for Ofgem's decision.

Background to the proposals

Existing Arrangements

UNC section V3 establishes that each Transporter will, in accordance with the Code Credit Rules[3] (CCR) determine and assign to each User a Code Credit Limit (CCL), which represents the maximum indebtedness that the Transporter will extend to the relevant User. A CCL is determined by dividing a User's estimated peak indebtedness (the predicted scale of charges (including VAT) for 63 days peak trading), by 85%[4] resulting in about 74 days equivalent of peak trading.

[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter
[2] This Licence Condition can be viewed at:
http://62.173.69.60/document_fetch.php?documentid=6547
[3] Rules established (and revised) by the Transporter and issued to Users
[4] This may subsequently be scaled back in line with Transporter portfolio category limits.

The CCR set out the following options, on which a CCL may be provided:

1. Unsecured, available to Users that possess an acceptable investment grade rating;
2. Secured, set by reference to the security provided[5]; and
3. Prepayment, one calendar month's estimated charges made in advance.

The best practice guidelines

In February 2005 Ofgem published its conclusions on best practice guidelines for gas and electricity network operator credit cover[6]. The document covered a wide range of issues which, in Ofgem's view strike an appropriate balance between providing protection against the risk of exposure in the event of default, and the costs of mitigating that risk. The conclusions document indicated that appropriate changes would need to be brought forward by parties to industry codes in order to arrive at credit cover arrangements consistent with the best practice guidelines.

In summary[7], Ofgem's conclusions in respect of setting unsecured credit limits are:

- User's unsecured credit limits should be set as a proportion of each Transporter's maximum unsecured credit limit for each User;
- The maximum unsecured credit limit for each User should be based on 2 per cent of the Transporter's Regulatory Asset Value (RAV);
- For Users with ratings of BB- and above, individual counterparty credit limits should be set using credit ratings;
- For unrated companies, and those with credit ratings of B+ or below, individual User credit limits should be set using either payment record or via independent assessment of creditworthiness;
- Users may aggregate their credit positions or use group ratings (for instance through Parent Company Guarantees (PCGs)), providing the arrangements are robust and unconditional. The limit will be applied to the contracting party or, subject to conditions, an affiliated credit support provider.

Ofgem's conclusions in respect of Value at Risk (VAR) are:

Unsecured credit should be extended to each User up to the applicable allowance from time to time. The amount of credit deemed to be taken at any time is the VAR from trading with a User. In relation to each User, the VAR for Use of System (UoS) charges at any time shall be the amount in money which is equal to the sum of:

(a) the aggregate value of all charges which at that time have been billed to such User (but not necessarily due) but remain unpaid; and

(b) a deemed amount equal to the aggregate value of all UoS charges that would be incurred in a fifteen day period at the same average daily rate implicit in billed charges under (a).

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[5] Which, amongst other things, includes a guarantee from the User's parent company (provided that it holds an acceptable investment grade rating)
[6] This document can be found on the Ofgem website at:
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/creditcover
[7] For full details, readers should refer to the conclusions document

This additional amount provides a proxy for UoS charges that are accrued but unbilled at any point in time, broadly in line with the time-weighted average of such charges arising in each monthly billing period.

The modification proposal

The proposal changes the number of days to be assessed in establishing the peak trading activity when determining the CCL. It is proposed to reduce the number from 63 days to 46 days peak trading activity, for both existing and new Users. The number 46 seems to have been based on the maximum number of days in a month plus 15.

Respondents' views[8]

There were ten responses to this modification proposal, of which five were in favour and five were opposed to implementation.

Comments in support of the proposal included that it contains a more realistic methodology for the calculation of VAR, which would enable Users to reduce the amount of credit that is unnecessarily lodged. Whilst it was noted that the proposal could result in some Users being subject to more cash calls, it was also highlighted that shippers have the ability to proactively manage their positions by providing additional cover in the appropriate form over winter months. In relation to the relevant objectives, one respondent considered that the proposal would promote Transporters' ability to operate in an efficient and economic manner.

Respondents who opposed implementation expressed concerns that the proposed VAR calculation would result in insufficient amounts of credit cover, and consequently in increased numbers of cash calls and associated administrative costs. The potential for pass through as a result of less credit cover being available in default situations was also highlighted.

Panel Recommendation

At the Modification Panel meeting held on 20 October 2005, of the 9 voting members present, capable of casting 10 votes, 5 votes were cast in favour of implementing this modification proposal. Therefore the Panel recommend non-implementation of this proposal[9].

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[8] This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. These can be found on the Gas Transporters information service (formally known as Nemysis) https://gtis.gasgovernance.com

[9] A Panel recommendation requires a majority vote from voting members at a quorate meeting of the Modification Panel. At the time of the vote, Paragraph 9.5.5 of the Modification Rules provided that where there are an equal number of votes in favour and not in favour of implementation, the Modification Panel is deemed to have recommended non-implementation. This was subsequently amended by UNC modification 039.

Ofgem's view

Whilst the title of this modification proposal indicates an intention to bring UNC credit cover arrangements into line with those set out in the conclusions document, this would not be its effect.

For the purposes of illustration, the following example has been provided:

Currently a User with transportation charges amounting to £100,000 per day over a peak period and with a credit rating of BBB (Standard and Poor's) would be afforded a Code Credit Limit of about £7.4m[10] (about 74 days of peak). In the light of the credit rating this sum would be unsecured. The proposal would have the effect of reducing the CCL to about £5.4m.

The current CCRs allow for a daily assessment of indebtedness to be made and it is this figure that is compared to the CCL to test whether, in the transporter's view sufficient cover has been provided. If the assessment of indebtedness exceeds 85% of the CCL then a Cash Call is issued to the User.

Ofgem recognises that reducing the current CCR methodology for the calculation of User CCLs from 63 days to 46 days peak trading would reduce CCLs correspondingly and this could potentially free up working capital that would otherwise be required as security. However, whilst this could reduce the amount of credit cover required from some Users, the triggers for Cash Calls have not been changed and indeed are not currently contained in the UNC. In the example above, under the proposal, the User could be cash called on the 47th day of peak trading which would be before the invoice for the period had actually been issued (typically the 51st day). Unless cash was forthcoming, the User could be in default before the due date for the invoice (typically the 63rd day). In this regard, Ofgem notes an estimate that the proposal could increase the number of notices sent by Transporters to Users during the winter period by 400 per cent.

Ofgem consider that one of the principles underlying the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable. However, Ofgem notes that increased monitoring and administrative actions, with associated costs for both relevant Transporters and Users, could reduce both stability and efficiency as compared to existing arrangements. Ofgem therefore considers that the potential costs associated with this proposal would outweigh prospective benefits.

Additionally, as noted above, in respect of the proposed legal text, whilst reference to use of 46 peak trading activity days in the mechanism for calculating CCL would be inserted into code, the mechanism itself would remain in the CCRs, which are not subject to UNC governance arrangements.

Ofgem is of the opinion that arrangements for credit cover should be governed by robust and transparent modification procedures. In this regard, Ofgem believes that credit arrangements that have the potential for material impact on Users should be incorporated within the UNC, thereby providing a clear and consistent approach across relevant networks, making it easier for both new entrants and existing participants to familiarise themselves within the market rules and arrange their businesses accordingly.

[10] This figure could be scaled back due to portfolio limits

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct the implementation of this modification, as Ofgem does not believe that it will better facilitate the achievement of the relevant objectives of the UNC, as set out in standard special condition A11 of relevant Gas Transporters Licences.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Nick Simpson
Director, Industry Codes and Licensing